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Subprime Securities Litigation: Key Players, Rising Stakes, and Emerging Trends

Part III of A NERA Insights Series

By Dr. Faten Sabry, Anmol Sinha, and Sungi Lee

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Previous topics in this subprime lending series include:

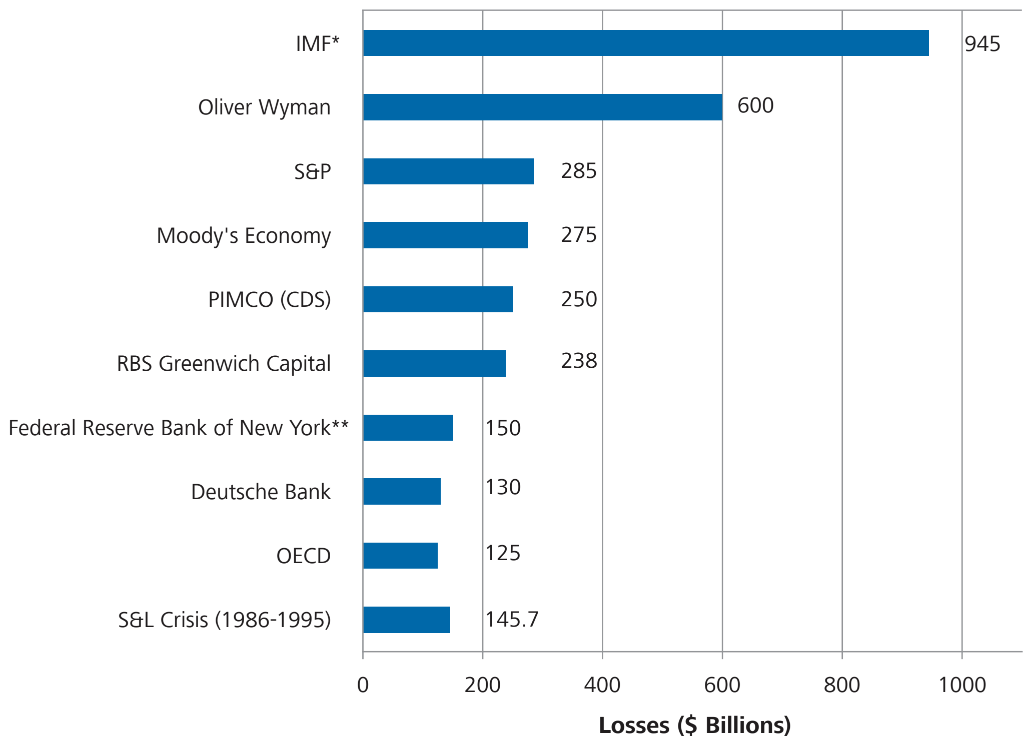
- The Subprime Meltdown: A Primer
- Understanding Accounting-Related Allegations

Introduction

The International Monetary Fund (IMF) estimates that the credit crisis will cost about $945 billion, the latest in a long list of estimates presented in Figure 1 below. No one knows the ultimate cost of the crisis, but it certainly will exceed the costs of the last major financial crisis presented by the collapse of the savings and loan industry. This problem began in the subprime mortgage market and then quickly spilled over into other areas of the mortgage industry and the capital markets, culminating in a liquidity and credit crisis that is still unfolding. Unsurprisingly, litigation has been on the rise.

This is the third installment of *NERA Insights: Subprime Lending Series*, a series of papers dedicated to the analysis of the subprime lending crisis. In Part I of the series, "The Subprime Meltdown: A Primer," NERA Vice President Dr. Faten Sabry and Consultant Dr. Thomas Schopflocher provide a brief overview of the subprime mortgage industry and the process of securitization. In Part II, "The Subprime Meltdown: Understanding Accounting-Related Allegations," NERA Senior Consultant Dr. Airat Chanyshev and former NERA Vice President Dr. Thomas Porter examine specific accounting issues that are cited in current litigation involving mortgage originators, and provide suggestions for how to analyze the pertinent accounting issues in subprime lending cases.

Figure 1. **Estimates of Losses Due to the Subprime and Credit Crises**



* Estimate is for the entire financial sector.
** Estimate is $100-200 billion.

Just as in the credit crisis, the lawsuits initially started in the mortgage industry. For the most part, these were suits against mortgage lenders. The subjects of litigation then moved on to be the issuers and underwriters of securities whose cash flows are backed by the principal and interest payments of mortgages. Now, the litigation has also engulfed investors who either purchased these securities or packaged them into other securities. As the liquidity crisis intensifies, areas that are not directly related to the subprime mortgage sector are starting to suffer losses, including the commercial paper market, the leveraged buyout industry, and auction-rate securities, to name a few examples. As the write-downs continue to accumulate, additional types of lawsuits are expected to emerge.

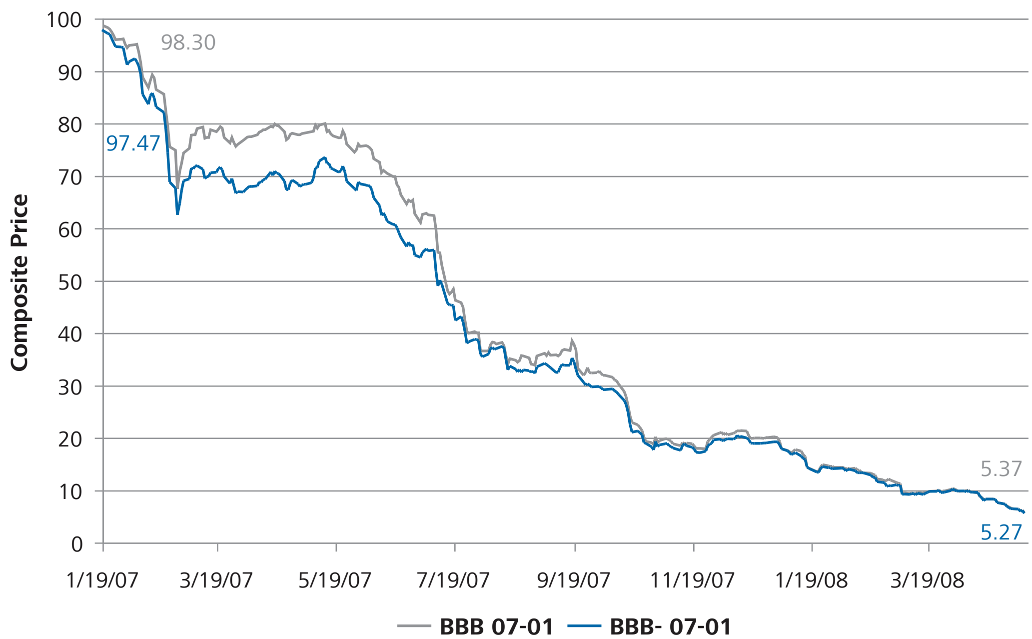
This article briefly examines the subprime mortgage-related securities litigation to assess the trends, major players, and issues. Some allegations are familiar from other types of disputes, yet others are somewhat novel. This is not meant to be a comprehensive account of all the cases and we do not report on commercial disputes or borrowers' predatory lending suits. Rather, we report the types of allegations brought by and against the various market participants. We searched for suits alleging wrongdoings associated with subprime assets—mortgages, mortgage backed securities, collateralized debt obligations (CDOs), etc. We compiled the data from various news sources including Bloomberg, Factiva, *Business Week*, the *Wall Street Journal*, and others from January 2007 to April 2008.

Background

The genesis of the crisis was in the subprime mortgage market—the market for lending to borrowers with poor credit histories—which expanded rapidly in the last decade. However, several economic factors, including the decline in national housing prices, caused the credit boom to stop and a reversal of fortune to begin. As delinquencies and foreclosures in subprime loans have increased, the values of securities backed by these loans have declined. The 2007 fourth quarter delinquency rate for subprime loans was 17.31%, the highest in the last eight years. As an aside, delinquencies in prime loans as well as credit cards have also started to increase.

The value of asset-backed securities (ABS) backed by subprime products has fallen as the performance of the subprime loans has continued to worsen. Figure 2 illustrates the value of two indices tracking the BBB rated and BBB- rated tranches of home equity deals based on loans from the last six months of 2006. An initial investment of $100 (on 19 January 2007) in the BBB index would have been worth only $5.46 by 8 May 2008; both indices showed a decline of almost 95% as of 8 May 2008.

Figure 2. **Index Values of Subprime Home Equity ABS Deals from the Second Half of 2006, 19 January 2007 to 8 May 2008**



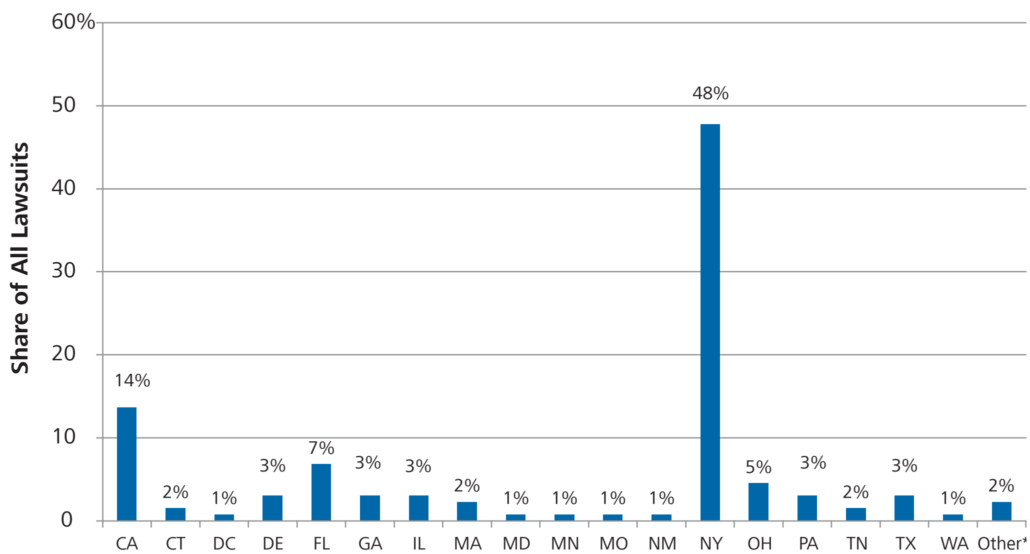
Source: Markit

Subprime Mortgage-Related Securities Lawsuits

Almost every market participant in the securitization process—which transforms illiquid assets such as mortgages, auto loans, and student loans into tradable securities—has been named as a defendant. The list of defendants includes lenders, issuers, underwriters, rating agencies, accounting firms, bond insurers, hedge funds, CDOs, and many more.

As of 21 April 2008, there had been 132 securities lawsuits related to subprime and credit issues (the count includes more than shareholder cases), of which 56 were filed since January 2008. New York has the most filings, with 48%, while California follows with 14% and Florida wraps up the top three with 7%. Filings in other states range between 1% and 5% (lawsuits by state are shown in Figure 3 below). This is consistent with recent trends in shareholder class actions, where the US circuit courts encompassing New York (Second Circuit), California (Ninth Circuit), and Florida (Eleventh Circuit) have seen the most activity in recent years.[1]

Figure 3. **Partial Count of Subprime-Related Lawsuits by State (through 21 April 2008)**

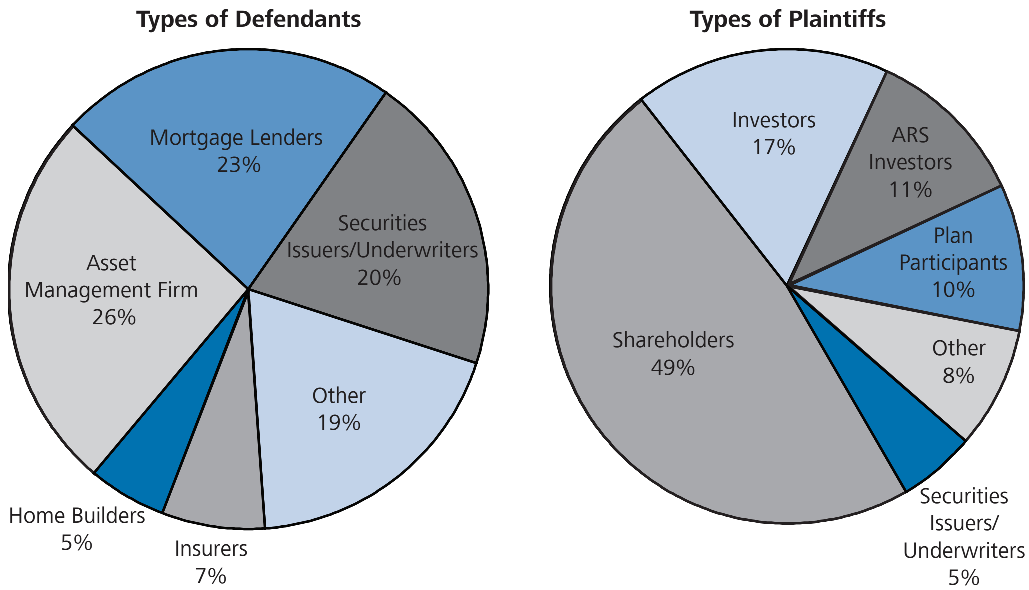


Notes & Sources: NERA collected lawsuits from various sources, including Factiva, Bloomberg, AP News, *Securities Law360*, *Wall Street Journal*, and *BusinessWeek*.
* "Other" represents lawsuits filed outside the United States.

The majority of the early lawsuits have been against mortgage lenders. As various other market participants reveal the extent of their losses and exposure, they too are being dragged into litigation. The plaintiffs include shareholders, investors, issuers and underwriters of securities, plan participants, and others. Figure 4 gives a breakdown of securities defendants and plaintiffs.

[1] Dr. Stephanie Plancich, Brian Saxton, and Svetlana Starykh, "2007 Year End Update: Recent Trends in Shareholder Class Actions: Filings Return to 2005 Levels as Subprime Cases Take Off; Average Settlements Hit New High," 21 December 2007, p. 5. The NERA study can be found here: http://www.nera.com/Publication.asp?p_ID=3364.

Figure 4. **The Players: Plaintiffs and Defendants (through 21 April 2008)**



Notes & Sources: NERA collected lawsuits from various sources, including Factiva, Bloomberg, AP News, *Securities Law360*, *Wall Street Journal*, *BusinessWeek*, and others. Lawsuits by shareholder plaintiffs include both shareholder class action and shareholder derivative cases. Lawsuits with asset management firm defendants include cases against mutual funds, hedge funds, and others.

Lawsuits Against Lenders

Subprime mortgage lenders face securities lawsuits from shareholders, borrowers, and issuers/underwriters. What complicates matters is that many of the lenders have filed for bankruptcy or have closed down. The allegations in these cases are mostly similar to suits filed in previous financial crises.

One of the earliest subprime shareholder class action cases was filed in February 2007 against New Century Financial and alleged a failure to disclose and properly account for the surge in forced repurchases of subprime loans. Other cases allege that the lenders concealed the size of, and failed to adequately reserve for, their subprime risk exposure.[2] Plaintiffs allege that mortgage assets were overvalued on balance sheets and that reserves for loan losses were inadequate. Shareholder class actions comprise almost half of the lawsuits thus far and the allegations are all very similar.

Various mortgage lenders, such as Countrywide and Fremont Mortgage Corp., also face Employee Retirement Income Security Act (ERISA) lawsuits, where plaintiffs allege that management's fraudulent actions caused the company's stock to collapse and thereby negatively affected employee contribution plans.[3,4] There are also ERISA/401(k) lawsuits pending against asset management firms, home builders, and securities issuers.

2. See, for example, *Robert Casey v. National City Corp.*, No. 08CV00209 (N.D. Ohio filed 24 January 2008).

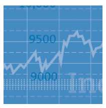
3. *Jonie L. Brockmeyer, et al. v. Countrywide Financial Corporation, et al.,* No. 2:07-cv-05906-RGK-CT (S.D. Cal. filed on 11 September 2007).

4. *Linda Sullivan, et al. v. Fremont General Corp., et al.,* No. 8:07-cv-00622-FMC-FFM (C.D. Cal. filed on 29 May 2007).

In addition, lenders are facing lawsuits from issuers for failure to buy back loans.[5] The plaintiffs allege negligence and lack of due diligence on creating the pools of mortgages underlying the securities and misrepresentations about the quality of the underlying assets.

Lawsuits Against Issuers

Securities issuers have also begun receiving an increasing number of securities lawsuits filed by lenders, shareholders, mortgage-backed securities investors, and their own employees. The list of securities issuers who are named as defendants includes Credit Suisse, HSBC, Lehman Brothers, Merrill Lynch, Citigroup, Washington Mutual, Bear Stearns, UBS, Morgan Stanley, Bank of America, and others.



Lawsuits by lenders are but one type of case that issuers are confronting. Lehman Brothers is facing a suit by American Home Mortgage Investment Corp. (AHMIC) related to repurchase financing it provided. Lehman was the "architect" of warehouse securitization programs for two special-purpose entities (SPEs) that helped fund mortgage originations by American Home Mortgage. The SPEs would finance the purchase of originated loans from American Home Mortgage by issuing commercial paper and subordinated notes. Two such notes were held as collateral by Lehman under a repurchase agreement and were eventually foreclosed on due to an alleged failure by AHMIC to meet margin calls. The suit claims that Lehman "unjustifiably pointed to the crisis of confidence in the mortgage arena instead of giving a fair, good faith valuation" on the collateral on which Lehman eventually foreclosed.[6]

Shareholder lawsuits again comprise the majority of cases against issuers. Cases such as the suit against Citigroup focus on charges during the class period of misrepresentation of exposure to the subprime sector and allegations of a failure to write down impaired securities backed by subprime loans.[7] As companies disclose the extent of their subprime losses and exposure, derivative products such as CDOs have become the centerpiece in many of these cases. CDOs are a highlight in the pending suit against Merrill Lynch, which contends that the company's statements were "materially false due to their failure to inform the market of the ticking time bomb in the Company's CDO portfolio due to the deteriorating subprime mortgage market."[8] Various other defendants, including bond insurers and asset management companies, face lawsuits involving CDOs. Some are discussed in the following sections.

Shareholders as well as ABS investors have also pursued litigation against issuers. Banker's Life Insurance Company filed suit in April 2007 regarding asset-backed securities purchased from Credit Suisse. The lawsuit alleges that Credit Suisse misrepresented the true value of some of its investment products and the underlying collateral, the majority of which were allegedly "shoddy, inferior

5. Some examples include *UBS Real Estate Securities, Inc. v. New Century Mortgage Corp., et al.,* No. 07-10416-KJC (Bankr. Del. filed on 5 April 2007) and *DLJ Mortgage Capital, Inc v. Netbank, Inc et al.,* No. 1:2006cv15211 (S.D.N.Y. filed on 18 December 2006).

6. Complaint for Plaintiff at 10, *American Home Mortgage Investment Corp. v. Lehman Brothers Inc., et al*., No. 07-11047 (Bankr. Del. filed on Oct. 24, 2007).

7. *Tillie Saltzman, et al. v. Citigroup Inc., et al.,* No. 07-CV-09901 (S.D.N.Y. filed on 8 November 2007).

8. Complaint for Plaintiff at 24, *Life Enrichment Foundation et al v. Merrill Lynch & Co., Inc. et al.,* No. 1:2007-cv-09633 (S.D.N.Y. filed on 30 October 2007).

9. Complaint for Plaintiff at 12, *Bankers Life Ins. Co v. Credit Suisse First Boston Corp.,* No. 8:07-cv-00690-EAK-MSS (M.D. Fla. filed 20 April 2007).

mortgage loans."[9]

Lawsuits Against Ratings Agencies

Ratings agencies are being accused of assigning excessively high ratings to bonds backed by risky subprime mortgages. Both Moody's and Standard & Poor's (McGraw-Hill is the parent company) face lawsuits alleging that, despite worsening conditions, the ratings agencies maintained high ratings on subprime-backed instruments. Plaintiffs allege misrepresentations and failures to disclose key information regarding the market conditions and their effects on company profitability.[10,11]

Lawsuits Against Bond Insurers

Charges of failure to disclose subprime exposure are not limited to lenders and issuers. Separate class action suits were brought against bond insurers MBIA and Ambac in January 2008. The allegations include misrepresentation of purported risk exposure and inadequate internal underwriting and ratings systems for products such as CDOs.[12,13]

Lawsuits Against Asset Management Companies

With complex derivatives securities like CDOs at the center of the crisis, several asset management companies are now facing lawsuits after experiencing losses in subprime-related securities. One such example is the suit by the German state-owned HSH Nordbank, which is suing UBS over its investment in a UBS-managed CDO. HSH Nordbank alleges that UBS misrepresented the credit quality of the investment and its underlying pool and "knowingly and deliberately created a compromised structure based upon less desirable collateral." HSH Nordbank is claiming a loss in excess of $275 million on its investment.[14]

Other lawsuits ask the courts to determine the respective interests of the defendants and other related parties in the distribution of interest and principal proceeds of a CDO.[15]

Morgan Keegan is facing a class action lawsuit that alleges that it misrepresented the risk of its funds' investments and that its "extraordinary losses in share value were not caused by economic or market forces." It goes on to assert that the funds "contained disproportionately large positions in the new untested structured financial instruments and other illiquid securities" such as CDOs, which contributed to its losses.[16]

As the losses mount and markets for products such as CDOs continue to unravel, some industry observers expect more lawsuits involving these complex securities.

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10. *Raphael Nach, et al. v. Linda Huber, et al.,* No. 1:07-cv-04071 (N.D. Ill. filed on 19 July 2007).

11. *Claude A. Reese, et al. v. Robert J. Bahash*, No. 1:07-cv-01530-CKK (D.D.C. filed on 27 August 2007).

12. *Steven Schmalz v. MBIA, Inc., et al.,* No. 08-CV-0264 (S.D.N.Y. filed on 11 January 2008).

13. *Scott Reimer, et al. v. Ambac Financial Group, Inc., Robert J. Genader, Philip B. Lassiter, Sean T. Leonard and Thomas J. Gandolfo*, No. 1:2008cv00411 (S.D.N.Y. filed on 16 January 2008).

14. Complaint for Plaintiff at 3, *HSH Nordbank AG v. UBS AG and UBS Securities LLC,* No. 2008-600562 (N.Y. Sup. Ct. filed on 25 February 2008).

15. See *Deutsche Bank Trust Co. Americas v. Lacrosse Fin. Prods, LLC.,* No. 1:08CV00955-LAK (S.D.N.Y. filed on 29 January 2008).

16. Complaint for Plaintiff at 16-17, *Richard A. Atkinson, M.D., et al. v. Morgan Asset Management, Inc., et al.*, No. 07-CV-02784 (W.D. Tenn. filed on Dec. 6, 2007).

Beyond Subprime: The Credit Crunch

So far, the lawsuits described above focus on market participants who are somewhat related to the subprime mortgage industry. However, as the subprime crisis gathered steam, sectors outside the subprime mortgage industry began to falter as well. The risk aversion created in the subprime sector caused investors to flee to higher quality securities, and the write-downs spiked. As seen above, lawsuits had followed the issues in the subprime mortgage-related realm; they did so again in the context of the trouble in the broader markets.

July 2007 began with an increase in spreads on the iTraxx Crossover index, which is an index measuring the cost of credit derivatives and is often regarded as a "barometer of investor appetite for corporate credit risk." The index crossed 3%; in mid-June, it was below 2%.[17] Signs of concern over credit quality became apparent as buyout firm KKR's banks failed to find investors for $10 billion worth of loans that were to help finance the purchase of Alliance Boots Plc.[18] Around the same time, banks for the Chrysler Group decided to delay the sale of $12 billion in debt due to the strained credit markets.[19]

Various companies and hedge funds soon began reporting losses due to the subprime meltdown and the ensuing turmoil in the credit markets. In August 2007, Sowood Capital Management announced that it was facing heavy losses due to "credit market troubles" that had wiped out 50% of its $3 billion in assets and that it would be shutting down.[20]

The crunch was not just a US phenomenon. In the first week of August, Australia's Macquarie Bank announced that two of its funds might lose as much as 25% of their value due to investments in securities linked to subprime loans.[21] In Germany, banks banded together to provide €3.5 billion to cover potential subprime-related losses for German lender IKB.[22] News also broke of the collapse of two Bear Stearns hedge funds.[23] In the days following, alarm over France's largest bank, BNP Paribas, halting withdrawals from three investment funds,[24] and a disclosure from Countrywide regarding short-term liquidity concerns due to "unprecedented" conditions in the credit markets,[25] culminated in a 3% drop in the US markets on 9 August.

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17. Mark Brown and Michael Wilson, "Deals & Dealmakers: Europe Feels U.S. Bond Market Chill" *The Wall Street Journal*, 12 July 2007.

18. Cecile Gutscher and Edward Evans, "KKR's Banks Fail to Sell $10 Billion of Boots Loans," Bloomberg Markets, 25 July 2007. <http://www.bloomberg.com/apps/news?pid=20601102&sid=abPIOg0EYQy0&refer=uk>

19. Dennis K. Berman, Serena Ng and Gina Chon, "Banks Delay Sale of Chrysler Debt As Market Stalls," *Wall Street Journal*, 25 July 2007.

20. Svea Herbst-Bayliss, "Harvard, Other Prominent Investors Lose on Sowood," Reuters, 1 August 2007.

21. Macquarie Bank Hit by Sub-Prime Loan Losses," *The Sydney Morning Herald,* 1 August 2007. <http://www.smh.com.au/news/business/macquarie-bank-hit-by-subprime-loan-losses/2007/08/01/1185647936914.html>

22. John O'Donnell and Jonathan Gould, "Germany's IKB Has $24-bln Subprime Exposure," Reuters, 2 August 2007. <http://www.reuters.com/article/bankingfinancial-SP/idUSL0288968420070802>

23. "Investors Take Action Against Bear Stearns Over Bankrupt Hedge Funds" Associated Press, 1 August 2007. <http://www.iht.com/articles/ap/2007/08/01/business/NA-FIN-COM-US-Bear-Funds.php>

24. Sebastian Boyd, "BNP Paribas Freezes Funds as Loan Losses Roil Markets." Bloomberg Markets, 9 August 2007. <http://www.bloomberg.com/apps/news?pid=20601087&refer=worldwide&sid=aNIJ.UO9Pzxw>

25. See Countrywide Financial Form 10-Q, filed 9 August 2007.

The market for commercial paper and commercial paper backed by securities seized up in that same week. Investors became increasingly nervous about the financial viability of their counterparties and lending almost came to a halt. By 10 August, the Federal Reserve had announced that it was "providing liquidity to facilitate the orderly functioning of financial markets."[26] In the two-day period of 9-10 August, the Fed and other central banks, including the European Central Bank, injected $290 billion into the financial markets as a stabilizing measure.[27] The subprime issue had now evolved into a credit crunch affecting the larger, global economy. As deleveraging continued, other sectors of the financial markets began to experience losses and receive lawsuits.

Lawsuits Related to Asset-Backed Commercial Papers

A Canadian unit of HSBC Holdings Plc. is facing a lawsuit by Aastra Technologies in Ontario. Aastra is alleging that HSBC gave bad investment recommendations in suggesting asset-backed commercial paper investments that were frozen soon after. HSBC is the first financial adviser to face a lawsuit over investments in asset-backed commercial paper.[28]

Lawsuits Related to Failed Deals

As investors' aversion to risk continued, the cost of borrowing increased and several merger deals fell through due to lack of funding. For example, in New York, Bain Capital and Thomas Lee Partners sued a group of banks, including Citigroup, Morgan Stanley, and Credit Suisse, that were to finance the plaintiffs' buyout of Clear Channel. The plaintiffs allege that the banks "balked" at their obligations due to the worsening credit conditions in mid-2007 even though the commitment was not subject to market conditions. They allege that the banks' actions are "especially appalling because the financing commitments they are flouting are the glue that holds commercial transactions together." The plaintiffs claim that "as a result of defendants' bad faith and willful breach of their contractual obligations, the Clear Channel transaction—which received the approval of Clear Channel's shareholders, as well as regulators—cannot proceed."[29]

Lawsuits Related to Corporate Debt Losses

Losses on investments in corporate debt have also led to various lawsuits. For example, iStar Financial is being sued by its shareholders for allegedly failing to recognize more than $200 million in losses on its corporate loan and debt portfolio in its registration statement for its secondary offering. The complaint alleges that the company was negatively impacted by the adverse conditions in the credit markets and this had a negative impact on its continuing operations at the time of the secondary offering.[30]

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26. See Federal Reserve Press Release, 10 August 2007: <http://www.federalreserve.gov/newsevents/press/monetary/20070810a.htm>

27. See the *Wall Street Journal's* Real Time Economics blog, 10 August 2007: <http://blogs.wsj.com/economics/2007/08/10/central-banks-react-to-liquidity-crisiss/>

28. Joe Schneider, "HSBC Sued in Ontario Over Commercial Paper Advice" Bloomberg Markets, 24 October 2007. <http://www.bloomberg.com/apps/news?pid=20601082&sid=aAIq1Frnq_UI&refer=canada>

29. Complaint for Plaintiff at 8-9, *BT Triple Crown Merger Co. Inc., et al. v. Citigroup Global Markets Inc., et al.,* No. 08-600899 (N.Y. filed on 26 March 2008).

30. Complaint for Plaintiff at 5-6, *Citiline Holdings, Inc., et al. v. iStar Financial Inc., et al.,* No. 1:2008cv03612 (S.D.N.Y filed on 15 April 2008).

Lawsuits Related to Auction-Rate Securities

Auction-rate securities (ARS)—long-term variable-rate instruments (usually municipal or corporate bonds) whose interest rates are reset through auctions—are a main source of funding for municipalities and have also been negatively affected. As a result of the credit crisis, many auctions began to fail. On 22 February 2008 alone, more than 70% of the publicly offered bond auctions failed. Prior to 2008, there were only 44 recorded failures since the ARS market's inception in 1984.[31] These failures are causing serious repercussions for municipalities like Jefferson County, Alabama, which is now facing rising interest rates on its bonds and demands for penalty payments as it struggles to avoid what would be the largest-ever bankruptcy of a US County.[32]

The ARS market problems have led to various lawsuits against broker-dealers such as Wachovia, Goldman Sachs, Wells Fargo, UBS, JP Morgan, Merrill Lynch, Morgan Stanley, TD Ameritrade, and others, all of which face allegations that they misrepresented the risk-level and liquidity of ARS they sold.[33] In addition, plaintiffs claim that defendants "failed to disclose that auction-rate securities were only liquid at the time of sale because the auction market was artificially supported and manipulated by various broker-dealers to maintain the appearance of liquidity and stability."[34]

As of 21 April 2008, there had been 15 lawsuits filed related to auction-rate securities, most of which were filed in March and April 2008.

Too Early to Tell

Most of the lawsuits are still in their initial stages and it is too early to predict the outcomes. The first subprime-related class action lawsuit against New Century Financial Corporation was dismissed in January 2008 without prejudice. Earlier, in November 2007, IndyMac Bank's motion for dismissal from the second amended complaint was granted—but with leave to amend—after the judge ruled against a "strong inference" of scienter.[35] Given the continuing turmoil in the financial markets, the mounting losses, and the growing list of lawsuits, this story is far from over.

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31. Jeremy Cooke, "Florida Schools, California Convert Auction-Rate Debt" Bloomberg Markets, 22 February 2008. <http://www.bloomberg.com/apps/news?pid=20601103&sid=awCJRyi5ngcQ&refer=us>

32. Martin Z. Braun and William Selway, "Jefferson County Advisers Meet With U.S. Officials," Bloomberg Markets, 10 April 2008, available at <http://www.bloomberg.com/apps/news?pid=20601109&refer=exclusive&sid=a4I6IcYPqovA>

33. *Judy D. Waldman, et al. v. Wachovia Corporation and Wachovia Securities, LLC,* No. 08-CV-02913 (S.D.N.Y filed 19 March 2008).

34. Complaint for Plaintiff at 2, *David M. Milch, et al. v. The Goldman Sachs Group, Inc. and Goldman, Sachs & Co,* No. 08-CV-3659 (S.D.N.Y filed on 18 April 2008).

35. *Claude A. Reese, et al. v. IndyMac Financial, Inc., Richard H. Wohl, and Scott Keys,* No. CV07-1635-GW (C.D. Cal. 9 November 2007) (order granting motion to dismiss without prejudice).

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Contact

For further information and questions, please contact:

Dr. Faten Sabry
Vice President
NERA Economic Consulting
+1 212 345 3285
faten.sabry@nera.com